

Internal Revenue Service
memorandum

date: DEC 27 1990

to: Special Trial Attorney, Western Region W:LA
(John O. Kent, Los Angeles District Counsel)

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED] Non Docketed
Your ref: [REDACTED]

This is a preliminary response to your request for Tax Litigation Advice dated December 11, 1990 and telefaxed to our office. You state that our immediate response is required, because the statute of limitations with respect to the taxable years under consideration will expire [REDACTED]. Because we will be unable to forward our formal response prior to [REDACTED], we are sending you our preliminary conclusions.

Specifically you ask whether the Los Angeles District of the Internal Revenue Service should make adjustments with respect to [REDACTED] affiliates of the above named taxpayer for the taxable year [REDACTED] based upon the affiliates' failure to use the sales method of accounting in computing income from the extraction and sale of natural gas subject to a gas balancing agreement. The Los Angeles District reasons that failure to use the sales method resulted in the income of the affiliates being computed in a manner that does not clearly reflect income.

We disagree. For the taxable year [REDACTED], the affiliates computed their income from the extraction and sale of natural gas under the entitlements method. However, we do not believe that the Service will be able to show that use of the entitlements method rather than the sales method of accounting does not clearly reflect income. This is true because the Service ordinarily would permit a taxpayer to change from one of these methods to the other in a subsequent taxable year, both methods are acceptable under standards of the accounting profession and both methods are commonly used throughout the entire oil and gas industry.

For the above reasons, we conclude that the Los Angeles District should be instructed that consistent use of the sales method is not required to clearly reflect income. Accordingly, the adjustments proposed with respect to this issue for the taxable year [REDACTED] should not be included in the final statutory notice of deficiency. In addition, you should inform Los Angeles Appeals that the related adjustments proposed for the taxable years [REDACTED] and [REDACTED] with respect to this issue should be conceded in full.

Alternatively, you ask whether the proposed adjustments can be supported under section 761(a) of the Internal Revenue Code of 1954. In effect, you would treat the parties to the joint venture as subject to the provisions of subchapter K and maintain that only an allocation based upon actual division of the proceeds from the sale of natural gas has economic


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substance. Currently, the Service allows parties to gas balancing agreements to elect out of subchapter K notwithstanding use of the entitlements method of accounting for their income. Accordingly, we do not believe that it would be advisable for the Service to litigate this issue at the present time through utilization of the subchapter K rationale.

If you have any questions concerning this memorandum, please phone the undersigned at FTS 566-3308. A more complete explanation of our views will be forwarded to your office as quickly as possible.

MARLENE GROSS
Assistant Chief Counsel
(Tax Litigation)

By:


PATRICK PUTZI
Special Counsel (Natural Resources)
Tax Litigation Division

cc: Deputy Regional Counsel (TL) CC:W
Manager Large Case Program CC
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